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THE LAW AND COMPUTERS
MATERIALS - 1983

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These materials have been compiled exclusively for
teaching purposes at the Faculty of Law, University
of Toronto and are not intended for publication.

Session IX: Taxation Issues

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INTRODUCTORY NOTE

Taxation is playing an increasingly important role in business transactions; no where is this more evident than in the computer industry. The tax implications will often be the deciding factor in how a transaction involving computer hardware and/or software will be structured. The material for this week seeks to introduce students to the current issues in the taxation of computer transactions, which involves a consideration of income tax, retail sales tax, federal sales tax and customs duties.

Historically, it was the practice of manufacturers of computer systems to lease their computers for a fixed price which included the hardware, software and services relating to the maintenance of the system. This arrangement was not complicated from a tax point of view. This changed in 1969 when the industry leader, IBM, decided to 'unbundle' their computer systems so that hardware and software would be sold on a separate basis. This has led to a number of difficult issues in dealing with the taxation of computer software and the emphasis in this section will be on these particular issues. It is not the purpose of the material to outline the taxation of computer systems generally; this can be obtained from the other sources referred to. Rather the purpose is to focus on the problem areas.

It should be noted that the material assumes a familiarity with the basic principles of income tax. Those students lacking this background are referred to any basic text on income tax, such as Grover and Iacobucci, Materials on Income Tax (5th ed.), Toronto, 1982.

It is worthwhile to clarify the meanings to be attached to terms throughout the course of the discussion. A computer system is composed of computer hardware and software. Hardware denotes the tangible components of the computer system. Software, the instructions that control the operation of the machine is of two general types for purposes of taxation. Operational software represents the instructions to the data processing equipment which facilitate the processing of information or data by translating into a form usable by the equipment. Such software is fundamental to the operation and maintenance of the system.

Application software, on the other hand, includes computer programs which have to do with the implementation of a system such as language compilers, general purpose utility programs and industry or other application programs. These systems are parallel to the methods and procedures used in manually performing such functions as inventory control, payroll systems, accounts receivables and payables.

Certain taxation authorities have further classified application software as either "canned" or "custom" software. "Canned" software is standard off-the-shelf software which requires little or no modification when sold to a particular customer. "Custom" software is software specially designed and coded for a particular customer.